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SUBJECT: BANKS STOPPING UK SUB-PRIME LENDING

Summary

¶1. (SBU) Over the last few months the UK has seen the virtual closure of its sub-prime market. Market conditions and action by the Financial Services Authority (FSA) against brokers for poor lending practices may have caused some banks to withdraw from the sub-prime market. The Financial Services Authority conducted an investigation into the sub-prime market and found deficiencies in all of the major players. Many of the lenders did not even comply with their own inadequate policies, with some failing to carry out basic checks on the plausibility of the information supplied by customers. The investigation led to fines against five companies. Citi told us its May 19 announcement that it is withdrawing from UK sub-prime mortgage lending, however, is not the result of the current turbulence in the UK sub-prime markets, but an internal assessment that it was not a significant product line for them.
End Summary

Background: The UK Sub-Prime Market

¶2. (U) There are a number of fundamental differences between the UK sub-prime lending market and the U.S. market. The most notable difference is the size of the markets. In a February 2008 press release, the UK's Intermediary Mortgage Lenders Association (IMLA) estimated that sub-prime mortgages account for only six percent of the UK market, in comparison to 20 percent in the U.S. There are also significant differences in the products available in the two markets. In particular, products with heavily discounted initial interest rates that are common in the U.S. are much less prevalent in the UK. Finally, businesses operating in the UK sub-prime market are regulated by the Financial Services Authority (FSA), in contrast to the U.S. where less than half of sub-prime lending is federally regulated.

¶3. (U) Sub-prime lenders bring more than half of UK repossession orders, despite accounting for only 6 percent of the UK mortgage market, according to a BBC investigation. The research found that over 10 percent of the cases were brought by just two sub-prime lenders, Southern Pacific Mortgage Limited and Preferred Mortgages, both owned by Lehman Brothers. Actual repossessions rose to an eight-year high of 27,000 in 2007 and analysts predict that conditions may deteriorate further this year, in part due to sub-prime lending.

Sub-Prime Lenders Closing Their Doors

¶4. (U) Over the last few months the UK has seen the virtual closure of its sub-prime market. In a speech to the Association of Mortgage Intermediaries May 15, Jonathan Fischel, Head of Mortgage and Credit Unions at the FSA, said that the number of sub-prime products has decreased by around 80 percent since July 2007. The majority of sub-prime and specialist lenders who relied on wholesale funding has

either pulled out of the market completely or is no longer offering sub-prime products. Advantage, the British sub-prime mortgage lender owned by Morgan Stanley, announced it will stop offering sub-prime loans on June 16 2008.

FSA Levies Fines for Poor Sub-Prime Broker Policies
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¶5. (U) On May 15, the FSA fined Thinc Group Limited, one of the UK's biggest mortgage brokers, GBP 900,000 for serious failures in its sub-prime business. The FSA said the Group did not have adequate risk management and compliance systems for its sub-prime mortgage business and that it failed to take reasonable care to ensure that it had records to prove that advice it gave to customers in relation to sub-prime mortgages was suitable. The fine comes almost a year after the FSA concluded its original investigation into the sub-prime market. The FSA's inquiry looked at eleven lenders, which represent more than half of the UK's sub-prime market, and found that none of the firms 'adequately covered' all of their responsible lending considerations in their policies. Many of the lenders did not even comply with their own inadequate policies, with some failing to carry out basic checks on the plausibility of the information supplied by customers. The investigation referred five companies, including Thinc, for enforcement. Of the other companies, The Loan Company was fined GBP 31,000, Next Generation GBP 10,500, and Homebuyers Security Ltd. and Aidan Mortgage Consultants had their permits rescinded.

The Citi Decision

¶6. (U) On May 19, Citi announced that its UK consumer operation will focus on its Citi and Egg brands and stop new lending through its

Future Mortgages (FM) and CitiFinancial (CF) operations while continuing to service existing borrowers. Alan Houmann Director European Government Affairs, told Econoff that Citi's decision came from internal reasons, rather than the state of the sub-prime market.

¶7. (SBU) When Vikram Pandit was named Chief Executive Officer of Citi December 7, 2007, he moved quickly to restructure the company's management organization, Houmann said. The old structure involved product silos with global responsibility for managing each product resting in New York. Pandit instituted a matrix organization where regional managers have responsibility for all businesses in their region thereby cutting across the product silos. Houmann stressed that Pandit has delegated profit and loss (PL) responsibility down from New York to the regional managers.

¶8. (SBU) According to Houmann, the global Citi review will be completed well before year end 2008. Regional management is reviewing each Citi business. Each business is labeled either core or legacy and evaluated based on a panoply of measures, including growth potential and profitability. Houmann said that given the small market share of CF and FM, managers at Citi were not surprised by the decision to shut them down. He said that the decision might well have been taken even without the sub-prime crisis and should not be viewed as being caused by it.

¶9. (SBU) Houmann said that FM and CF were purchased in 2000 and 2001 respectively. Both operate exclusively in the UK. CF is a full spectrum lender focusing on unsecured personal loans. It currently has less than a one percent market share. FM is Citi's intermediary secured loans operation and offers first and second secured loans through mortgage brokers. FM also has less than a one percent market share. The Times reported on May 20 that CF operates 49 branches with 300 employees and a call centre in Doxford with 400 employees. Houmann said Citi is working hard to find jobs internally for the redundant employees, but stressed that the global review is expected to result in a significant reduction in fixed costs (read as employees). Accordingly, many of those affected will likely not find new positions within Citi.

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